

TESTIMONY OF

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On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

On

ACCELERATING LOAN MODIFICATIONS, IMPROVING FORECLOSURE
PREVENTION, AND ENHANCING ENFORCEMENT

Before the
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

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Good morning, Chairman Frank, ranking member Bachus, and members of the Committee. I am Mark Pearce, Deputy Commissioner of Banks for the state of North Carolina. I am pleased to be here today to discuss efforts already underway at the state level and future efforts needed to improve the pace and volume of modifications to mortgage loans that will help homeowners stay in their houses.

I appear today as a member of the State Foreclosure Prevention Working Group, a joint effort of state attorneys general, state bank regulators, and the Conference of State Bank Supervisors (CSBS). CSBS is the professional association of state officials responsible for chartering, supervising, and regulating the nation's 6,206 state-chartered commercial and savings banks, and 400 state-licensed foreign banking offices nationwide. For more than a century, CSBS has given state bank supervisors a national forum to coordinate, communicate, advocate and educate on behalf of state bank regulation.

In addition to regulating state-chartered banks, the states provide regulatory oversight of the residential mortgage industry. State mortgage regulators work together through their own organization, the American Association of Residential Mortgage Regulators (AARMR), of which I am also Vice President and legislative and policy liaison with CSBS. Additionally, I am a member of the State Foreclosure Prevention Working Group chaired by Iowa Attorney General Tom Miller.

In total, states regulate and oversee more than 90,000 mortgage companies with 63,000 branches and 280,000 loan officers and other professionals.¹

In my testimony today, I want to place the rising delinquency and foreclosure rates in context of the subprime origination market over the past couple of years and the traditional operation of mortgage servicers. This context is essential to understanding the limitations on and opportunities for preventing unnecessary foreclosures. In particular, I wish to make the following points:

1. **Mortgage servicers are being asked to fix problems created by poor origination practices over the past few years.** Loose underwriting practices, especially in the subprime market, led to a significant number of risky mortgage loans dependent on continued home price appreciation. Many subprime loans have experienced severe delinquency rates before the rates reset, as a result of weak or nonexistent underwriting, risk layering, fraud, and/or life events. Rate resets for hybrid adjustable rate mortgages exacerbate this problem, but are only one aspect of a larger challenge of dealing with risky subprime loans.
2. **A significant disconnect between aspirations and results remains as servicers struggle to meet the current and ongoing foreclosure crisis.** Mortgage servicing operations historically have been structured to promote efficiency in collection of regular mortgage payments. Their loss mitigation

¹ The above numbers do not include the State of California's Department of Real Estate's approximately 480,000 licensed real estate agents who could also function as a mortgage broker under their license.

efforts have traditionally been limited to a small percentage of borrowers in default who are most often dealing with adverse life events, such as loss of a job, health problems, or divorce. This collections system was not designed to deal with a large number of homeowners with longer-term problems created by payment shock, house price depreciation, and limited refinance options. While servicer executives are to be applauded for their encouraging statements on efforts to prevent foreclosures, the reality has been that many homeowners, non-profit counselors, and state officials are frustrated by the inability of servicers to make sustainable loan modifications that would benefit borrowers and investors alike. The transition from a “no touch” or “low touch” debt collection model to a “high touch” foreclosure avoidance model has been and continues to be very bumpy.

3. **Proposing to freeze rates for current homeowners that will default due to payment shock is an important step forward.** Investors will benefit from systemic approaches to prevent large numbers of homeowners facing payment increases from entering into foreclosure. This makes good economic sense. The success of any proposed rate freeze will depend on the ability of servicers to analyze likelihood of default in advance and make a pre-qualified offer to modify the loan for at least five years. If servicers continue to use the traditional “waterfall” system, which relies on extensive homeowner interaction and documentation requirements, this rate freeze option will never reach many eligible homeowners. While dealing with rate reset loans may prevent a number of unnecessary defaults, we should not be lulled into thinking this proposal solves the foreclosure crisis. As Treasury Secretary Paulson has said, freezing rates for a portion of borrowers facing rate resets is not a silver bullet. We are at the start of this road, not the end.
4. **States will continue to work with subprime servicers in a collaborative fashion to monitor progress of foreclosure prevention efforts and to promote systemic and innovative approaches.** State attorneys general and state banking and mortgage regulators have worked with the 20 largest subprime servicers for several months regarding this crisis. We have sought opportunities to discuss innovative approaches to preventing foreclosures, recognizing that servicers have important contractual obligations to investors and that not every foreclosure can be avoided. We believe these efforts will improve servicers’ ability to prevent unnecessary foreclosures and will track progress through our collection of data on loss mitigation activities. States continue to seek cooperation with federal efforts in this arena, as we continue our traditional role in protecting our citizens.

State Efforts Regarding Foreclosure Prevention

This Committee has already heard from the state regulators multiple times on their efforts to improve regulation of the mortgage market. We believe state and federal cooperative approaches have the best chance to eliminate regulatory gaps, and we continue to work to

make sure regulators are better able to address weak lending practices. In addition to our regulatory efforts, state officials have also been very active in addressing increasing foreclosures. Despite these efforts, we believe the current situation of elevated foreclosures is only the tip of the iceberg.

State banking and mortgage regulators have been working together formally with State Attorneys General during the past year to develop a comprehensive strategy to address increasing foreclosure rates. The partnership between state regulators and attorneys general is long-standing, and had led to the largest consumer protection settlements in our nation's history, including most recently the \$325 million settlement with Ameriquest.

In July 2007, representatives of 37 state attorney general offices and state banking regulators gathered in Chicago for a summit meeting on the growing crisis in subprime mortgage foreclosures. The news was alarming: nearly two million subprime mortgages with an adjustment feature, such as hybrid ARMs and option ARMs, were set to adjust between the latter part of 2007 and the end of 2008. These loans had been made with an expectation that borrowers could refinance before the rate adjusted, an expectation that was no longer justified in light of the rapid decline in home values. Many of these loans had been made based on incorrect stated incomes and/or inflated appraisals, with little if any underwriting having been done to assure that borrowers could afford to make monthly payments after the initial "teaser" rate had adjusted upward. The likely outcome of this situation was an unprecedented flood of foreclosures.

A State Foreclosure Prevention Working Group formed out of this summit meeting, to gather more information and to attempt to work with participants in the subprime mortgage industry to find ways to modify loans on a mass scale so that as many borrowers as possible could retain their homes with affordable mortgages. The Working Group consists of representatives of the attorneys general of 11 states, two state banking departments, and the Conference of State Bank Supervisors.

Since September, this Working Group has met with representatives of the 20 largest servicers of subprime mortgages. Collectively, these top 20 companies service approximately 93 percent of the nation's subprime loans. We have asked them to work with us to start identifying and implementing collective, consistent and scaleable solutions to prevent foreclosure. Our guiding principle is simple: any solution must be in the interests of both the borrower and the investor. We see ample opportunities for improvement that will lead to win-wins for investors and homeowners.

In addition to the multi-state joint effort of the State Foreclosure Prevention Working Group, individual states have taken the initiative to reduce foreclosures through various efforts, such as:

- foreclosure prevention hotlines, such as those in Iowa, Colorado, and Massachusetts;
- hosting "road shows" of servicers in hard-hit economic areas, such as Ohio and Michigan, to promote face-to-face contact between servicers and struggling homeowners;

- meeting directly with servicers in states such as Texas, Ohio, and California, to determine if there are solutions to local problems;
- foreclosure moratoriums to deal with abusive lending practices of particular lenders; and
- enactment of legislation to improve servicing practices.

Numerous states have foreclosure prevention task forces that bring together local resources to deal with local conditions. In this case, Ohio is truly not the same as North Carolina.

Foreclosure Impact at the Local and State Level

At the state level, we see the impact of foreclosures at every level of daily life. Our citizens contact our offices for assistance in avoiding foreclosure. Our court systems are clogged with foreclosure proceedings. We see the “for sale” and “auction” signs in our neighborhoods. From an economic perspective, borrowers who lose their homes to foreclosure no longer pay property taxes and many local communities may suffer a fiscal strain as a result. Any subsequent owner is likely to be paying lower property taxes, as the property’s value declines, and the values of homes around a house in foreclosure often decline as well, further depressing tax revenues. A recent report by Global Insight for the U.S. Conference of Mayors looked at the fiscal impact of the mortgage crisis on ten states, and estimated an aggregate loss in tax revenue of \$6.6 billion. A November 2007 report by the Center for Responsible Lending found that each foreclosure lowers the value of other neighboring homes by 0.9 percent. The CRL estimates a total decline in house values and tax base from nearby foreclosures to be \$223 *billion*.

Traditionally, foreclosures occurred because of a weak economy or a major life event, such as job loss, divorce, or illness. While life events have not disappeared and unemployment and economic weakness might be rising, these factors are still at historically low levels. The differences in today’s mortgage market are the types of mortgage products being used, the lower standards for loan underwriting, and unprecedented levels of origination fraud. A recent report from Fitch found that “poor underwriting quality and fraud may account for as much as one-quarter of the underperformance of recent vintage subprime residential mortgage-backed securities.” This 25% estimate by Fitch may well be conservative, based on the states’ experience. According to the latest findings of the Mortgage Asset Research Institute (MARI), mortgage fraud reports increased 30% from 2005 to 2006 alone, and estimated losses due to mortgage fraud last year approached \$1 billion dollars.

While lending practices are not the topic of today’s hearing, it is critical to understand that today’s foreclosure crisis is the fruit of the poor underwriting and lending practices in prior years. For instance, many of the hybrid adjustable rate mortgages facing resets in the next year were made to borrowers based on limited or no documentation. If those borrowers had been offered fixed rate loans with fully documented incomes, many of these borrowers would have paid a *lower* rate than the initial “teaser” rate of the hybrid

ARMs. We would not have a rate reset problem at all; in fact, we would have *fewer* borrowers facing foreclosure.

As a result of systemic weakness in underwriting of these loans, we need systemic solutions to preventing foreclosure. These systemic solutions are made difficult by the very design of mortgage servicing operations.

Servicing for Good Times

This Committee has thoroughly discussed the fragmentation of the mortgage origination system and the moral hazard created throughout the chain from loan broker to investor and addressed these issues in H.R. 3915. In addition, the fragmented system extends into the servicing operation, as specialized mortgage servicers developed to manage prime, subprime, and “scratch and dent” mortgage loans.

For the most part, these servicers’ essential function is to collect monthly payments from borrowers and to remit them in a timely manner to investors. Servicers compete for the opportunity to service mortgage portfolios and have developed highly automated and efficient systems to collect these payments quickly and accurately. When borrowers fall behind on mortgage loans, servicers perform their other primary function, that of a debt collector. Like other debt collections, this process is highly scripted and intended to maximize the likelihood of getting the borrower to catch up on the mortgage or, in the alternative, to regain control of the property as quickly as possible to enable the property to be resold.

Over the past few years, with rising property values nationwide, most subprime loans would refinance prior to any rate reset event. Many servicers have reported that upwards of 70% of subprime loans historically repaid prior to the reset, as borrowers either refinanced the loan or sold the property. Loss mitigation efforts focused on short-term repayment plans, which were directed to those borrowers who had a temporary problem. If collections didn’t work and short-term repayment plans didn’t work, servicers would typically move forward to foreclosure. Servicers rarely, if ever, offered a loan modification. This “waterfall” approach from collections to loan modification meant that modification was the last resort.

Now that property values are declining in many markets, these options have dried up, and servicers report that the percentage of loans that refinance prior to the reset have plummeted to 20-30%. The rest of the loans continue to move toward reset and many of those face likely default as their payment increases. Instead of traditional life events, these homeowners face a long-term problem in that their mortgage payment will increase by 20-30%, assuming interest rates stay steady. Given the turmoil in the credit markets, even this assumption is dubious. Other homeowners have such a high debt-to-income ratio or such little equity in their homes that even the slightest change in their financial situation can lead to ruin.

As the root causes of foreclosure change, servicers have struggled to adapt their approach to solve systemic and large-scale problems created by weak origination practices. Servicers have made significant efforts, but in part, they have failed for two reasons: first, because the legal infrastructure to conduct scalable solutions has evolved in incremental steps; and second, servicer efforts have not adapted systemically to new drivers of foreclosures.

First, we should celebrate the creative legal solutions to enhancing servicer ability to engage in loan modifications. From interpretations of FAS 140, to REMIC rules on passive investments, to guidance to servicers on their duty to the aggregate investment trust, to revisions in pooling and servicing agreements (PSAs), investors and regulators have made tremendous progress in removing legal obstacles to increasing the availability of loan modifications. This is an incredibly complex area, and talented people have made a difference.

Problems remain, however, in that traditional notions of “case-by-case” assessment of individual borrowers capacity to repay have hampered the implementation of scalable loan modifications. Most servicers have been reluctant to offer a loan modification without a full and detailed financial assessment of the individual borrower’s current financial condition – such as cellphone and cable bills, how much the homeowner spends on food -- a much more rigorous review than would occur in the underwriting of loans on the front end. While subprime lenders may have engaged in weak underwriting, servicers have traditionally over-underwritten loan modifications to ensure they comply with legal obligations to investors to maximize the value of each loan individually.

Hesitant to make major changes in approach for fear of investor lawsuits or loss of business, servicers have attempted to meet the demand for loan modifications simply by adding additional staff in the loss mitigation area. While these efforts are beneficial, they have not been able to keep up with the increasing volume of homeowners in distress. In addition, the highly individualized assessment needed in the current system requires a higher level of training than do front-line collections. Modifying a loan means spending a great deal of time with a borrower, money not recoverable from investors. In fact, intensive loss mitigation efforts can lose money for a servicer if the benefit from keeping the payment stream of future servicing fees outweighs the cost of the staff time needed to modify a loan successfully.

Based on our reports from our consumer assistance departments, local and national non-profit counselors, and the media, homeowners are still having tremendous difficulty in accessing loss mitigation solutions. Homeowners are having difficulty reaching someone with the authority to make a loss mitigation decision, paperwork gets lost, processing takes weeks or months to finalize a modification. Even state officials have had difficulty in navigating various servicers to find the right person to assist a homeowner. While it is possible that no one benefits from foreclosure, the current system still produces them unnecessarily and sometimes simply as the result of poor customer service.

Another strong servicer effort – increased outreach to borrowers -- has run into similar problems. As has been frequently cited, up to 50% of borrowers who are foreclosed on report that they never talked to their servicers. Servicers identify contacting borrowers as the primary obstacle to foreclosure prevention. As a result, servicers have implemented an array of innovative techniques to reach borrowers, such as mailing cellphones to borrowers, sending letters that look like wedding invitations, contracting with local non-profits to deliver letters personally, and holding “open houses” in local areas hard-hit by foreclosures. These creative techniques are coupled with persistent and frequent phone calls to try to reach borrowers, and this has undoubtedly prevented foreclosures.

In this area, servicers have struggled to combat the negative impression that servicers are simply uncaring debt collectors who do not have options other than foreclosure. In fact, the research on borrower contact identifies that perception as the primary reason that borrowers did not contact their servicers. As a result, many homeowners ignore or avoid contact with servicers. It will take more than creative outreach to combat this problem. Recent efforts to partner with non-profits are critical in this area, and state and local officials are partnering with servicers in some areas to contact hard-to-reach homeowners.

Ultimately, the proof is in the pudding. A recent report by Credit Suisse developed a scale to determine how many loan modifications were being made as compared to the number that should have been made, based on loans that went delinquent within a few months after the rate reset. Even the issuer with the highest percentage modified only approximately one-third of the loans needing modification. Simply put, the energetic efforts of servicers have not translated into meaningful success in preventing large numbers of foreclosure.

Freezing Rates to Avoid Payment Shock is an Important Step Forward

Chairman Bair of the FDIC should be given great credit for her leadership in proposing that servicers develop a systemic approach to dealing with hybrid ARMs before they have rates reset. In California, Governor Schwarzenegger and the California Department of Corporations have announced an agreement with four major servicers to extend the rate on hybrid ARMs for a sustainable period.

The Treasury Department’s HOPE NOW initiative, and the proposed freezing of rate resets for certain borrowers reported last week, are efforts toward goals similar to those of our State Foreclosure Prevention Working Group. While the details of this agreement are not yet available, we believe that this approach is the type of scalable solution that will prevent unnecessary foreclosures. In particular we hope this proposal includes the following components:

1. Servicers should take steps to identify owner-occupied hybrid adjustable-rate subprime loans that will face a payment reset within the next six months.

2. For those loans, the servicer should take steps, using available data, to determine whether the homeowner is reasonably likely to default on the loan if the homeowner has to make the monthly payment post-reset. This calculation should be based on a traditional net present value analysis of the modified loan vs. the value of the loan in foreclosure. This assessment should be done without the need to collect specific financial information from borrowers in advance, as most servicers have access to sufficient financial information (e.g. original loan information, payment history and credit reporting) to make this assessment prior to borrower contact.
3. For loans that are *current* at the time of the assessment, and where an increased payment makes it reasonably foreseeable that a default will occur, the servicer should develop a “pre-qualified” loan modification offer. This loan modification offer should be one where the interest rate of the loan is frozen at the current level for the remaining life of the loan or for at least five years, if not for the life of the loan. Given the high volume of delinquent subprime portfolios nationwide, longer-term changes to rate for these loans will enable servicers to focus limited loss mitigation resources on delinquent loans, rather than cycling back through performing loans.
4. This pre-qualified loan modification offer should be clearly communicated to the borrower. The offer should be contingent on the homeowner providing a reasonable confirmation of the homeowner’s existing financial condition.
5. The pre-qualified loan modification offer should include a direct contact number to the loss mitigation department of the servicer, in the event the homeowner has questions or individual financial conditions that might impact the option.

Recent press has mistakenly characterized this type of scalable solution as a “bailout.” We believe this is wrong for three critical reasons. First, this proposal best serves the interests of investors and homeowners. Investors’ financial returns will improve as a result of a systemic approach to this issue, rather than allowing 80-90% of the loans to enter default before getting serious attention from loss mitigation staff at the servicer.

Second, no government money is involved in this proposal. Investors who made poor financial investments will bear the brunt of those choices. Many borrowers who receive this type of modification will be those who could have obtained a fixed rate loan at a similar price two years ago, if they had provided full documentation of income.

Finally, as high foreclosures accelerate home price declines, slowing down foreclosures not only benefits individual homeowners, but also protects aggregate property values and the health of our communities and economy. The serious negative externalities associated with foreclosures, such as reduced property values, increased crime, deterioration of properties, etc., make foreclosure levels of this magnitude a public policy issue. Given that we are experiencing the first nationwide home price decline in our

lifetimes, mitigating foreclosures gives our markets a chance to recover rather than spiral further downward.

Challenges Ahead

While it would be tempting to think that the proposed freezing of rates for some hybrid ARMs would solve the foreclosure problem, we have much more work to do. Given that many subprime loans originated in 2006 are already showing historic levels of default, continued efforts are necessary to find ways to promote long-term affordable solutions to prevent foreclosures. Some areas that need additional work are:

- Finding creative loss mitigation techniques to deal with struggling homeowners who are “under water” due to home price declines. The use of balloon modifications may maximize homeownership preservation for those willing to stay in the home, while creating an opportunity for investors to recover their principal if the market rebounds.
- Solving the problem of piggyback second mortgages. Many subprime loans in recent years were 80/20 loans, where the first and second mortgages were securitized into different instruments, serviced by different servicers. Struggling homeowners may face competing servicers contacting them to seek payment for different mortgages. This creates incredible pressure and confusion for the homeowner. In addition, the investors (and servicers as agents) have competing interests and may struggle to find a mutually acceptable loss mitigation outcome to preserve homeownership.
- Reducing paperwork necessary to consummate a loan modification. Traditional servicing techniques have required extensive documentation to justify a loan modification. Servicers need to develop and implement processes that require less paperwork.
- Improved customer service to provide homeowners with the right solution on the first phone call. If homeowners have to talk to five different people at a servicer before accessing the appropriate solution, many will fall through the cracks.
- Providing meaningful data to the public through state and federal officials to demonstrate progress of loss mitigation efforts.
- H.R. 4178 offers the basis for enhanced protection for servicers making best efforts to prevent unnecessary foreclosures. While broad immunity shouldn't be necessary given that these loan modification efforts are in the interests of investors, the reality is that every servicer we have talked to believes they will be sued by investors; the question is not if, but when. Congress can mitigate this problem, assuming the bill does not violate contracts and the Constitution. Any legislative immunity, however, should be limited strictly to investor lawsuits.
- Investors should be willing to reimburse servicers for work with independent third-party counselors. It is in investors' interest to pay servicers or housing counselors an additional fee for modifications that result in performing loans. The American Securitization Forum's recent paper on this topic will hopefully lead to broader investor acceptance of this reimbursement of independent counselors assisting in foreclosure prevention.

- A close look at pay-option ARM products, as a potential “second wave” of resets may occur as these loans reach their negative amortization caps. We should get out ahead of these resets.

Next Steps for State Foreclosure Prevention Work Group

The State Foreclosure Prevention Working Group’s meetings with the top 20 subprime servicers highlighted the need for meaningful data on the extent and type of modifications actually being offered, and on progress in preventing foreclosures. Servicers need information about each other’s practices and procedures in order to develop industry-wide best practices, and a consistent approach to these modifications.

Therefore, the Working Group has developed and sent out a “call report” for servicers, in an attempt to collect essential information. The Consolidated State Report for Mortgage Servicers asks servicers for data on their total loans serviced; the characteristics of these loans; the number and amounts of prime, subprime and Alt-A loans that will reset and when; the past-due and default rates on each of these categories; and what steps the servicer has taken to prevent foreclosures, ranging from deed in lieu of foreclosure to loan modification. The Working Group has shared the call report format with a number of state and federal regulators, including members of the HOPE NOW initiative. We anticipate receiving data from servicers in this format within the next couple weeks.

Collecting this information will give us a better understanding of the scope of the problem and the current state of loss mitigation efforts by the servicers. It should allow both regulators and the industry to track our progress and to move past anecdotal stories of success or failure.

We will continue to work with these servicers in a collaborative and cooperative fashion to identify ways to prevent needless foreclosures. Where appropriate, there are opportunities for collaboration between state and federal regulators. In fact, CSBS has briefed all the federal banking regulators and OFHEO about the progress of the State Foreclosure Prevention Working Group, and hope to work with federal agencies as they continue their efforts. There is great opportunity for partnership and innovation, as we need our collective efforts to mitigate the national foreclosure crisis.

Conclusion

States have a critical stake in preventing foreclosures and keeping committed homeowners in their houses. What is a macroeconomic issue for the nation’s economy is, at our level, a question of reduced tax revenues, blighted neighborhoods, increased crime and demands on social services, and even civic instability.

We are spending our time and resources on this issue because it is so important to our citizens and our neighborhoods, and we ask Congress to recognize and include our efforts in any comprehensive approach to foreclosure prevention.

We intend to continue our work with you, the industry and with our counterparts nationwide to minimize the impact of this surging disaster in communities across the nation. Thank you for your time and attention, and I would be happy to answer any questions you may have.